Introduction

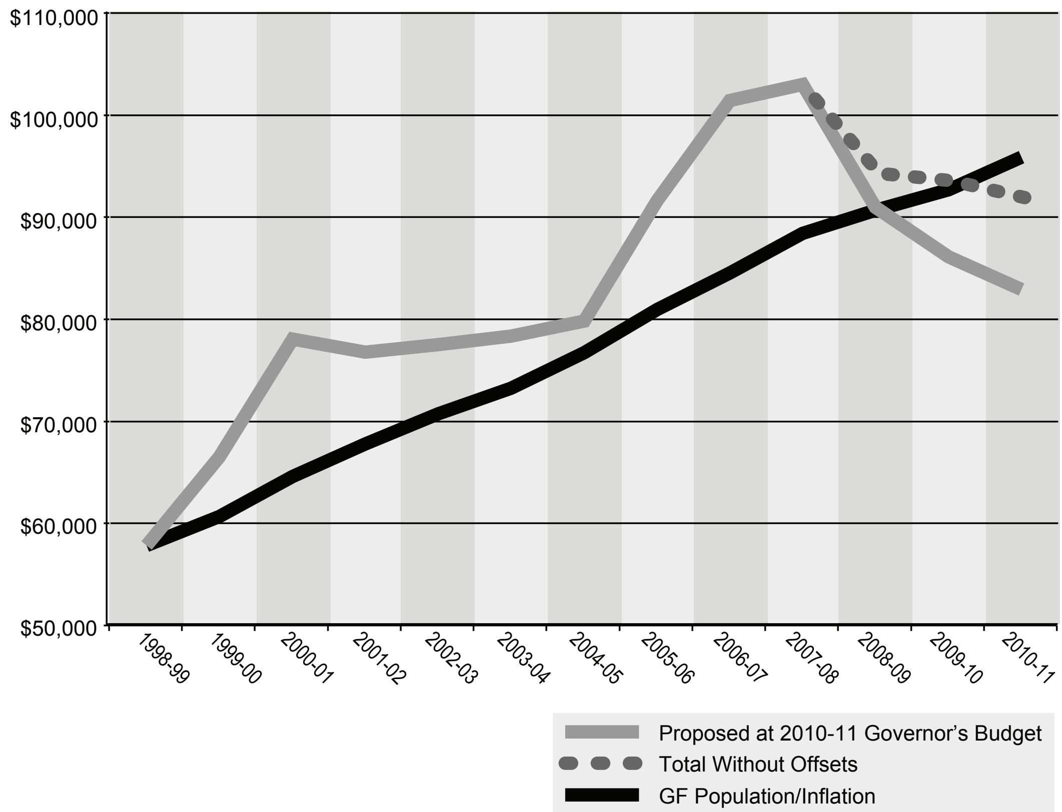
In 2009, the United States confronted the most severe economic downturn since the Great Depression. As a result, most states faced a budget gap of unprecedented proportions. California made very difficult but necessary decisions to close a $60 billion budget gap and to successfully manage our cash reserves to avert a fiscal crisis. The 2009-10 budget plan contained substantial spending reductions, program eliminations, revenue increase and other solutions, many of which are not available on an ongoing basis. In addition to closing the budget gap, California adopted reforms in nearly every area of government to contain costs into the future. The Governor's Budget includes even further reductions to many programs while fully funding the Proposition 98 guarantee to schools and avoiding additional deep cuts to the classroom and higher education. If these proposals are adopted, it would bring overall General Fund spending to a level well below what it was a decade ago in 1998-99 adjusted for population and inflation growth. (See Figure INT-01.)

The budget projects that California is slowly emerging from the recession. While the recovery has begun, economic growth is very modest and high unemployment persists. Baseline revenues fell by more than 20 percent from their peak, and they are expected to remain for several years approximately 30 percent lower than 2007-08 projections, as shown in Figure INT-02. Major components of this revenue decline are: capital gains taxes ($8 billion), income tax on wages (about $6 billion), tax on other components of income ($7 billion), sales taxes ($11 billion), corporate taxes ($2 billion) and all other taxes ($1 billion). These revenues are not poised for rapid recovery. Consumer spending driven by easy credit and growth in home values is also not likely to return to prior levels in the

Figure INT-01

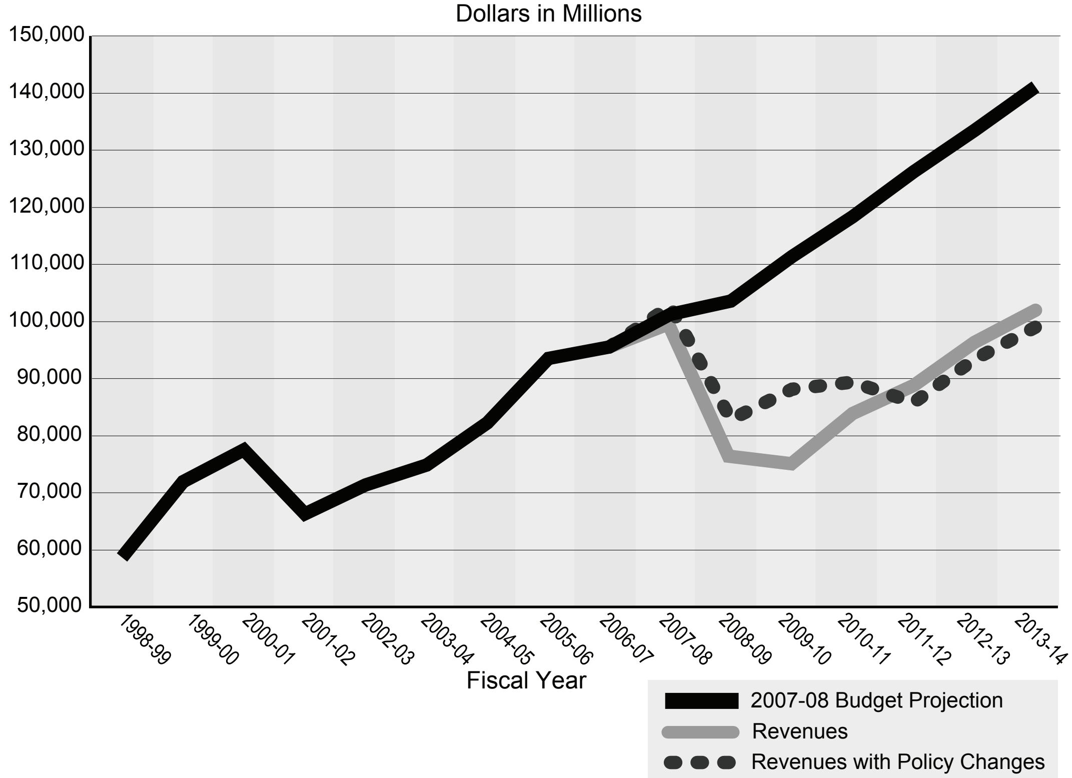
Proposed General Fund Spending Would Remain Below Population and Inflation Growth

(Dollars in Millions)



foreseeable future. Revenues will also be affected by the expiration of temporary tax increases enacted last year.

Figure INT-02
Impact of Recession on Revenues
Dollars in Millions



Defining the Budget Gap

Without corrective action, California is projected to face a budget gap of $19.9 billion in fiscal year 2010-11. This figure is comprised of a current year shortfall of $6.6 billion, a budget year shortfall of $12.3 billion, and a modest reserve of $1 billion.

As Figure INT-03 shows, various factors contribute to the increase in the 2010-11 deficit from the $6.9 billion that was projected when the 2009-10 Budget was enacted. Specifically, revenue estimates are $3.4 billion lower, federal and state court decisions have reduced or eliminated budget solutions adopted in previous years and imposed costs totaling $4.9 billion, erosions of previous solutions result in $2.3 billion of the budget gap, and population and caseload growth adds $1.4 billion in costs.

Figure INT-03
Shortfall in 2010-11 Governor's Budget
(Dollars in Billions)

June 30, 2011, Reserve Projected as of Amended 2009 Budget Act		-$6.9
Workload Adjustments:		-12.0
Revenue Decline	-3.4	
Federal and State Court Litigation	-4.9	
Erosions of Other Previously Enacted Solutions	-2.3	
Other Population and Caseload Growth	-1.4	
Rebuild Reserve		-1.0
Budget Shortfall		-$19.9

Closing the Budget Gap

The Governor's Budget proposes a combination of spending reductions, alternative funding, fund shifts and additional federal funds to close the $19.9 billion budget gap. Given the re-emergence of a current year shortfall and the necessary time for budget solutions to achieve their full value, it is imperative that many of the solutions proposed in the budget be adopted immediately. Therefore, the Governor will declare a fiscal emergency and call the Legislature into Special Session. The budget proposes solutions for action in the Special Session that will close $8.9 billion of the budget gap. Delays in the adoption of these proposals until the enactment of the 2010-11 budget would result in the loss of up to $2.4 billion in budgetary solutions and thereby necessitate even deeper cuts in 2010-11.

Figure INT-04 shows the categories of solutions proposed. Spending reductions account for $8.5 billion in solutions. Proposed reductions include program eliminations, further reductions to various health and human services programs, a reduction to the anticipated level of funding for Proposition 98, substantial changes to employee compensation, and reductions to the Department of Corrections and Rehabilitation.

Figure INT-04
Proposed Budget Solutions
(Dollars in Billions)

	2009-10	2010-11	Total	
Expenditure Reductions	$1,034	$7,475	$8,509	43%
Federal Funds	8	6,905	6,913	35%
Alternative Funding	150	3,736	3,886	20%
Fund Shifts and Other Revenues	0	572	572	3%
Total	$1,192	$18,688	$19,880	100%

Reforming the Federal-State Relationship

The budget proposes structural changes in the state and federal relationship to address federal constraints on California's ability to effectively manage program costs within available resources and proposes that California be reimbursed for money owed to the state. These program reforms and recoupment of federal funding will provide $6.9 billion in solutions to address next year's shortfall and help reduce projected deficits into the future.

Federal mandates, including spending requirements, constraints on program reductions and federal court decisions delaying reductions of services have contributed more than $1.4 billion toward the current budget gap. Federal and state court decisions have limited the state's ability to reduce program costs and restricted the state's ability to provide services to those most in need within available resources. Federal maintenance-of-effort requirements and court decisions have also forced increased program spending by hundreds of millions of dollars per year. Lastly, underfunded federal mandates are costing California billions of dollars each year, resulting in California taxpayers subsidizing higher reimbursement rates being paid to other states.

California needs greater federal flexibility to more effectively manage program costs in state and federal programs within available resources. Without this flexibility and without the level of federal funding proposed in the budget, California will be forced to make even more difficult spending reductions. If the federal flexibility and funding do not materialize, then additional spending reductions, delays in tax cuts and continued suspension or reduction of tax credits must go into effect.

Reductions, Flexibility, and Reimbursements Owed

The budget proposes various reductions to more effectively manage program costs. These reductions require that California have the necessary flexibility to manage program costs and to better target program services within available resources. The following reductions require such flexibility:

- Medi-Cal Cost Containment Strategies—The Governor's Budget includes a reduction of $750 million General Fund from the implementation of strategies, similar to what other states have done, to reduce Medi-Cal costs including limits on services and utilization controls, and increased cost-sharing through co-payment requirements, premiums, or both.
- In-Home Supportive Services (IHSS)—The budget includes a reduction of $77.9 million in 2009-10 and $872.6 million in 2010-11 for limiting the provision of services to consumers with the highest level of need and reducing state participation in the wages of IHSS workers.
- Department of Corrections and Rehabilitation's Medical Services Program—Reduce the federal Receiver's budget by $811 million to reduce per-inmate medical costs to a level comparable to other correctional health care programs.

The budget also seeks federal reimbursement for the following that is owed to California:

- Increase the federal matching fund rate for Medicaid to the national average from the current base Federal Medical Assistance Percentage (FMAP) rate for California from 50 percent to 57 percent ($1.8 billion). This increase would reflect the national average as well as the average of the ten most populous Medicaid states.
- Secure reimbursement for costs that should have been paid by Medicare and changes in the required level of state payment for Medicare prescription drug benefits ($1 billion).
- Reimbursement for special education mandates at a level commensurate with the requirements under federal law ($1 billion).
- Full reimbursement for the cost of incarcerating undocumented immigrants through the State Criminal Alien Assistance Program ($879.7 million).
- Expanded federal funding for foster care cases ($94.4 million).

The budget also assumes continuation of a portion of the federal American Recovery and Reinvestment Act funding for various health and human services programs ($2.1 billion).

Trigger Reductions and Revenues

The budget identifies spending reductions and extension of revenue increases (listed below) that will go into effect in the event that the federal government fails to provide the $6.9 billion of additional funding proposed in the budget. The cash gain or savings from these trigger solutions will ensure the state has the ability to repay any external borrowing.

Reductions ($4.6 billion General Fund)

These reductions impact spending that is within the state's control and are allowable under existing federal law.

- Eliminate the California Work Opportunity and Responsibility to Kids (CalWORKs) Program ($1.044 billion).
- Fund existing mental health services with Proposition 63 funds ($847 million).
- Reduce Medi-Cal eligibility to the minimum allowed under current federal law and eliminate most remaining optional benefits ($532 million).
- Reduce state employee salaries by an additional 5 percent ($508 million).
- Eliminate the IHHS Program ($495 million).
- Redirect additional county savings ($325 million).
- Eliminate non-court required inmate rehabilitation programs, implement banked parole for low-risk serious and violent offenders, expand crimes where convicted felons will serve time in local jails, and increase the number of parolees each agent will supervise ($280 million).
- Eliminate the Healthy Families Program ($126 million).
- Eliminate funding for enrollment growth at the University of California and the California State University ($111.9 million).
- Eliminate various health services programs funded by Proposition 99 ($115 million).
- Make an unallocated reduction to trial courts ($100 million).
- Freeze the level of the awards and income eligibility for Cal Grants ($79 million).
- Eliminate funding for the Transitional Housing Placement for Foster Youth-Plus Program ($36 million).

Revenues ($2.4 billion General Fund)

For one year,

- Extend suspension of a business's ability to reduce taxable income by applying net operating losses (NOL) from prior years to reduce current income ($1.2 billion).
- Extend reduction in the credit for each dependent on the personal income tax from $319 to $102 ($504 million).
- Delay use of business credits by unitary groups of corporations and instead retain current law which requires subsidiaries to have their own tax liability to use research and development and other credits ($315 million).
- Delay the change to the single sales factor allocation method for multi-state corporate income and instead retain the double weighted sales, property, and payroll formula ($300 million).
- Lower to 30 percent the first year phase-in of the ability of corporations to carry back losses two years to offset prior tax profits ($20 million).

Plan to Address Anticipated Cash Shortfall

Last year, the budget projected that the state would not have sufficient cash to make all General Fund payments in a timely manner beginning in March of 2009. To address this significant cash shortfall, the budget proposed a combination of budget and cash solutions. Given the magnitude of the anticipated shortfall and delays in the adoption of necessary solutions, the state suspended loans from the Pooled Money Investment Account for capital projects and delayed issuance of taxpayer refunds. In February 2009, the state adopted both budget and cash solutions to better align the state's disbursements and receipts, and to reduce the need for external financing. Subsequently, a budget and cash gap re-emerged. For the second time since the Great Depression, California issued registered warrants (IOUs) to preserve cash for essential payments. The enactment of the Amended 2009 Budget Act brought the budget back into balance and facilitated the issuance of Revenue Anticipation Notes (RANs) to restore timely payment by the state. The re-emergence of a budget shortfall, however, threatens to undermine the state's cash management plan.

The Governor's Budget projects the state will have sufficient cash to repay the entire $8.8 billion of RANs in May and June 2010 as scheduled, although it will face cash challenges in March 2010. However, absent corrective action, the state will once again face substantial challenges in meeting all General Fund cash needs beginning in July 2010. Proposals to close the budget gap will substantially reduce this cash gap. However, in addition to budget solutions, the state will need to obtain external financing early in the fiscal year. Further, it is likely that payment deferrals will still be required to align receipts and disbursements and to reduce the need for external borrowing. At the Governor's direction, the Department of Finance will work with the State Controller's Office and the State Treasurer's Office to develop additional cash solutions to be submitted to the Legislature in the Special Session.